Commentary
Fixed Income

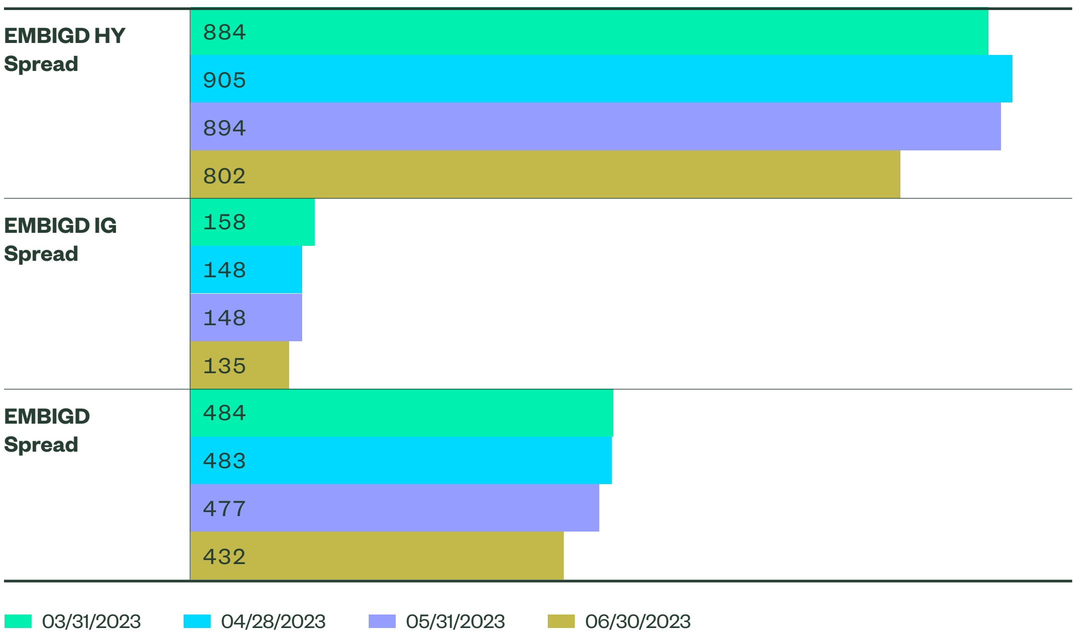
Q2 2023

Emerging Market Debt
Market Commentary: Q2 2023

Chart of the Quarter: Narrowing Hard Currency Sovereign Spreads

Among emerging market hard currency sovereign bonds, there was a notable narrowing of high yield spreads over the latest quarter amid easing investor concerns and improving risk sentiment. Downward revisions to medium-term recession projections likely contributed to this spread-tightening as the quarter progressed.

Figure 1
EM Hard Currency Sovereign Spreads (Basis Points)



Source: Bloomberg Finance L.P., JP Morgan as of 30 June 2023. Past performance is not a reliable indicator of future performance.

EMD Commentary — Q2 2023

At the start of the second quarter, emerging market (EM) debt struggled for direction in the aftermath of the market turbulence that stemmed from banking sector concerns in the US and Europe. Investor risk appetite was initially low as markets sought greater clarity on how the latest events might impact the Federal Reserve's policy path. Such concerns eased later in April as strong US bank earnings reports provided greater comfort around balance sheets. Despite easing inflation pressures and the high carry on offer with EM debt, performance in May was hit by concerns surrounding a possible US debt default as debt ceiling talks dragged on. However, the end of May brought relief in the form of a tentative agreement between US President Joe Biden and Speaker of the House Kevin McCarthy to raise the US debt ceiling. Despite underwhelming growth data from China, the quarter ended on a relatively stronger footing for emerging markets with lower volatility and narrowing spreads.

The market-implied probability of additional policy rate hikes by the Fed increased, notwithstanding a pause in the rate hike cycle in June. However, the Fed's decision to pause did not have a material impact on the policy stances of most EM central banks, whose tightening cycles are more skewed towards domestic inflation dynamics. Headline inflation peaked across the EM universe, with downside inflation surprises being observed. In a major shift from President Recep Tayyip Erdogan's unorthodox policies to tame inflation (which included rate cuts), Turkey's central bank raised its main interest rate from 8.5% to 15% in an effort to shore up depleting reserves. Meanwhile, softening growth data from China impacted commodity demand, especially for industrial metals. After trending lower through most of the quarter, crude oil prices rebounded in June, aided by a drop in inventory levels and plans by some producers to reduce supply. Performance of some Latin American EM economies with a higher beta towards commodity prices were impacted as a result.

Net flows during the quarter for hard currency and local currency funds were -$6.9bn and +$1.4bn, respectively.[1]

Figure 2
Emerging Market Debt Index Returns — As of 30 June 2023

	1m (%)	3m (%)	6m (%)	YTD (%)	12m (%)	3yrs (%)	5yrs (%)
In USD							
GBI-EM GD (EM Local Currency)	3.26	2.51	7.79	7.79	11.38	-1.42	0.29
EMBI GD (EM Hard Currency)	2.23	2.19	4.09	4.09	7.39	-3.10	0.55
CEMBI BD (EM Corporates)	1.08	1.37	3.64	3.64	5.66	-0.52	2.40
In EUR							
GBI-EM GD (EM Local Currency)	0.90	2.08	5.45	5.45	6.73	-0.46	1.66
EMBI GD (EM Hard Currency)	-0.10	1.76	1.82	1.82	2.90	-2.16	1.93
CEMBI BD (EM Corporates)	-1.23	0.95	1.39	1.39	1.25	0.45	3.80
In GBP							
GBI-EM GD (EM Local Currency)	0.66	-0.31	1.99	1.99	6.40	-2.35	1.05
EMBI GD (EM Hard Currency)	-0.34	-0.62	-1.52	-1.52	2.58	-4.02	1.32
CEMBI BD (EM Corporates)	-1.46	-1.41	-1.94	-1.94	0.93	-1.46	3.17

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 30 June 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Performance returns for periods of less than one year are not annualized.

Figure 3
ESG Emerging Market Debt Index Returns — As of 30 June, 2023

	1m (%)	3m (%)	6m (%)	YTD (%)	12m (%)	3yrs (%)	5yrs (%)
In USD							
JESG GBI-EM (ESG EM Local Currency)	3.62	3.06	8.86	8.86	13.25	-1.22	0.39
JESG EMBI (ESG EM Hard Currency)	1.97	1.93	3.91	3.91	6.82	-3.90	0.42

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 30 June 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Performance returns for periods of less than one year are not annualized.

Figure 4
Key EM and Macro Levels as of 30 June 2023

Item	Δ 1 Month	Δ 3 Months	Δ YTD	Current Level
GBI-EM GD Yield	-12 bps	-27 bps	-53 bps	6.32%
EMBI GD Yield	-26 bps	-14 bps	-19 bps	8.37%
EMBI GD Spread	-45 bps	-52 bps	-20 bps	432 bps
CEMBI BD Yield	-10 bps	10 bps	-3 bps	7.36%
CEMBI BD Spread	-34 bps	-35 bps	-13 bps	363 bps
CDX.EM 5y	-33 bps	-16 bps	-25 bps	213 bps
10y UST	19 bps	37 bps	-4 bps	3.84%
Dollar Index (DXY)	-1.36%	0.40%	-0.59%	—
DOW 30	4.56%	3.41%	3.80%	34408
Oil (WTI)	3.75%	-6.65%	-11.99%	$ 70.64

Source: JP Morgan, Bloomberg as of 30 June, 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Local Currency Market Highlights

EM local currency debt returned 2.51% (in USD terms) in Q2 2023, as measured by the JP Morgan GBI-EM Global Diversified Index. A major contribution came from bond returns (+2.77%), as local bond yields fell (-27 bps) amid a general stabilization in the tightening cycles of EM central banks. The upward trend in real yields, backed by receding inflation and the potential for the first rate cuts by EM central banks in this cycle, added to the momentum. Negative FX returns (-0.27%) detracted from performance in the quarter; the uptrend in the US dollar observed in May as a result of stronger growth data weighed on EM FX returns.

Figure 5
Key Return Drivers of EM Local Government Bond Markets

GBI-EM GD (EM Local Currency)	Monthly Return (%)	3-Month Return (%)	YTD Return (%)
In USD			
Total Return (in $)	**3.26**	**2.51**	**7.79**
FX Return (vs $)	1.67	-0.27	2.08
Price Return (Local currency)	1.15	1.46	3.06
Interest Return (Local currency)	0.44	1.31	2.66
In EUR			
Total Return (in €)	**0.90**	**2.08**	**5.45**
FX Return (vs €)	-0.69	-0.69	-0.27
In GBP			
Total Return (in €)	**0.66**	**-0.31**	**1.99**
FX Return (vs €)	-0.93	-3.08	-3.73

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 30 June, 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Performance returns for periods of less than one year are not annualized.

Figure 6
Best and worst performers across EM local government bond markets in USD*

Q2 '23	Country	Total Return USD (%)	Bond Return (%)	FX Return (%)	Index Weight (%)	Index Impact (bps)**
GBI-EM GD		**2.51**	**2.77**	**-0.27**	—	—
Top 5 Performers	Colombia	19.5	7.1	12.4	4.6	89
	Hungary	12.1	9.4	2.6	3.1	38
	Brazil	11.8	6.4	5.4	10.0	118
	Uruguay	10.1	6.1	4.0	0.1	1
	Peru	9.8	5.8	4.0	2.6	25
Bottom 5 Performers	China	-3.8	1.7	-5.5	10.0	-38
	Thailand	-4.2	-0.7	-3.5	10.0	-42
	Malaysia	-4.2	1.3	-5.5	10.0	-42
	South Africa	-7.5	-1.5	-6.0	8.4	-63
	Turkey	-29.5	-4.2	-25.3	0.9	-27

Source: State Street Global Advisors, JP Morgan, Bloomberg as of 30 June 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.
* Country and currency performance of JP Morgan GBI-EM Global Diversified Index.
** Index impact is calculated by multiplying the period ending weight by total return.

Colombia was the best performer in Q2. The country's annual inflation rate eased to 12.36% in May, the lowest print since last October. In line with market expectations, Colombia's central bank left its benchmark rate unchanged at 13.25% at its June meeting as the bank's steepest ever tightening cycle appears to be beginning to have the desired effect on the economy. The Colombian peso appreciated by 9.8% against the US dollar in Q2, closing at 4,171.7.

Hungarian local bonds also performed well in the quarter. The National Bank of Hungary lowered its one-day deposit rate by 100 basis points to 16.0% at its June meeting, following a similar rate cut in May. The annual inflation rate cooled for the fourth consecutive month to 21.5%, an outcome below market forecasts of 22.3%. The Hungarian forint appreciated by 2.5% against the US dollar in Q2, closing at 341.6.

Brazil was another good performer in Q2. Increased government spending and an agricultural boom supported economic growth prospects. The annual inflation rate fell to 3.94% in May, the lowest reading since October 2020 and the third month in a row that the rate has been below the central bank's upper limit of 4.75%. Markets continued to price in a greater probability of rate cuts in the third quarter. The Brazilian real appreciated by 5.5% against the US dollar in Q2, closing June at 4.8.

Turkey was the worst performer in Q2 against the backdrop of presidential elections in May. To address the rapid deterioration in economic conditions, the Central Bank of Turkey raised its benchmark one-week repo rate by 650 bps to 15% at its June meeting (although this was below market expectations of an increase to 21%). The central bank affirmed its stance that it will continue to tighten policy in a gradual manner. The Turkish lira depreciated against the US dollar by 35.6% in Q2 and closed at 26.

South Africa local bonds performed poorly in Q2. Early in the quarter, markets priced in the possibility of South Africa being sanctioned after the US alleged the country had supplied arms to Russia. In May, the central bank surprised markets with its tenth consecutive rate hike, with a 50bps increase taking the benchmark interest rate to 8.25%. The South African rand depreciated against the US dollar by 5.9% in Q2 and closed at 18.8.

Performance Comparison of JPM Local Currency Benchmark vs ESG Local Currency Benchmark

Figure 7
Key Return Drivers of ESG EM Local Government Bond Markets

JESG GBI-EM (ESG EM Local Currency)	Monthly Return (%)	3-Month Return (%)	YTD Return (%)
In USD			
Total Return (in $)	**3.62**	**3.06**	**8.86**
FX Return (vs $)	1.96	0.14	2.82
Price Return (Local currency)	1.24	1.65	3.47
Interest Return (Local currency)	0.42	1.27	2.57

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 30 June, 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

The JP Morgan ESG GBI-EM Index returned 3.06% (in USD terms) in Q2 2023, thereby outperforming the JP Morgan GBI-EM Global Diversified Index by 0.56%. This excess return was driven by relative index overweights in the European countries of Hungary (+1.7%) and Poland (+1.8%), which contributed 0.21% and 0.16% to these excess returns, respectively. Underweights in China (-3.8%) and Turkey (-0.3%) also contributed positively by 0.14% and 0.10%, respectively, while an underweight in Brazil (-0.7%) detracted 0.08% as Brazil performed well during the period.

Hard Currency Market Highlights

EM hard currency sovereign debt returned 2.19% (in USD terms) in Q2 2023, as measured by the JP Morgan EMBI Global Diversified Index. The spread returns (+3.97%) contributed significantly, as the spreads tightened (-45 bps in June) towards the quarter-end on the back of EM HY/IG compression and easing recessionary concerns. The yield on 10-year US Treasurys increased during the quarter by 37 bps as the Fed maintained a hawkish tone despite leaving rates unchanged in June. The lack of clear direction in EM credit during the early part of the quarter weighed on investor sentiment, contributing to outflows from EM hard currency markets. These factors impacted the Treasury component, which detracted from quarterly performance (-1.71%).

Figure 8
Key Return Drivers of EM Hard Currency Government Bond Markets in USD

EMBI GD (EM Hard Currency)	Monthly Return (%)	3 Month Return (%)	YTD Return (%)
Total Return	**2.23**	**2.19**	**4.09**
Spread Return	3.24	3.97	2.58
Treasury Return	-0.97	-1.71	1.47
IG Sub-Index	0.49	0.62	3.44
HY Sub-Index	4.13	3.89	4.79

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 30 June 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Performance returns for periods of less than one year are not annualized.

Figure 9
Best and Worst Performers Across EM Hard Currency Government Bond Markets*

Q2 '23	Country	Total Return (%)	Spread Return (%)	Treasury Return (%)	Average Index Weight (%)	Index Impact (bps)**
EMBI Global Diversified		**2.19**	**3.97**	**-1.71**		
Top 5 Performers	Pakistan	42.0	42.6	-0.5	0.7	28
	Ukraine	35.4	36.7	-1.0	0.7	26
	Zambia	28.1	27.9	0.1	0.3	7
	El Salvador	27.2	28.8	-1.2	0.6	15
	Sri Lanka	25.5	25.8	-0.3	0.8	20
Bottom 5 Performers	Kuwait	-0.4	1.0	-1.3	0.7	0
	Poland	-0.6	0.5	-1.1	1.8	-1
	Guatemala	-0.8	0.7	-1.5	1.0	-1
	Egypt	-2.5	-1.6	-0.9	2.2	-5
	Venezuela	-20.8	-21.3	0.7	0.0	0

Source: State Street Global Advisors, JP Morgan, Bloomberg as of 30 June 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.
*Country and currency performance of JPM EMBI Global Diversified Index.
**Index impact is calculated by multiplying the period ending weight by total return.

Pakistan was the best performer in Q2, contributing 28bps to the index return. Investor concerns relating to a potential sovereign default eased as the country clinched a last-minute deal for a bailout by the International Monetary Fund (IMF). The IMF reached a staff-level agreement with the Pakistani authorities on a USD 3 billion Stand-by Arrangement for a period of nine months.

Ukraine was another good performer in Q2, contributing 26bps to the index return. The yield on Ukraine's 10-Year sovereign US dollar bond ended June at 32.8%, down from 37.9% at the start of the quarter. The World Bank approved a $1.5 billion loan to Ukraine, guaranteed by the government of Japan. The loan will support the strengthening of the country's social protection system.

Sri Lanka also performed well in Q2, contributing 20bps to the index return. The country announced a restructuring plan for its domestic debt in an effort to meet the targets set by the IMF in return for the recent bailout. The island state has requested that its international sovereign bond investors take a 30% haircut (with a six-year maturity at a 4% interest rate). The annual inflation rate eased to 12% in June, a significant quarter-on-quarter drop from 50.4% at the end of the first quarter.

Egypt was one of the poorest performers in Q2 as the country continued to face external financing constraints. Inflation was persistently high and stood at 32.7% in May, up from 30.6% in April, and well above the central bank's target range of 5%-to-9%. Fitch Ratings downgraded Egypt's Long-Term Foreign-Currency Issuer Default Rating to 'B' from 'B+', with a Negative Outlook. Moody's kept Egypt's foreign and local currency issuer ratings on review for downgrades.

Poland was another underperformer, detracting 1bp from the index return. The recently-observed slowdown in consumption and sales dented the growth expectations for 2023. Investor sentiment was hit by the country's ruling party, which shuffled its campaign team in a bid to regain traction four months ahead of the Polish parliamentary elections.

Performance Comparison of JPM Hard Currency Benchmark vs ESG Hard Currency Benchmark

Figure 10
Key Return Drivers of ESG EM Hard Currency Government Bond Markets in USD

JESG EMBI (ESG EM Hard Currency)	Monthly Return (%)	3 Month Return (%)	YTD Return (%)
Total Return	**1.97**	**1.93**	**3.91**
Spread Return	2.94	3.74	2.32
Treasury Return	-0.95	-1.74	1.56
IG Sub-Index	0.57	0.68	3.48
HY Sub-Index	3.88	3.62	4.48

Sources: State Street Global Advisors, Bloomberg, JP Morgan as of 30 June 2023. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

The JP Morgan ESG EMBI hard currency index returned 1.93% (in USD terms) for Q2 2023, underperforming the JP Morgan EMBI Global Diversified Index by 0.26%. The improvement in market sentiment over the course of the quarter drove the performance of higher yielding countries in particular, which saw a narrowing of spreads in the latter part of the quarter. This latter move benefited the countries in the ESG benchmark to a greater extent and helped to narrow the performance differential.

Endnote

1 Source: JP Morgan.

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* Pensions & Investments Research Center, as of December 31, 2021.
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